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Office-Supreme Court, U.S.
FILED
MAR 15 1961
JAMES R. BROWNING, Clerk

Nos. 151 and 169

In the Supreme Court of the United States

OCTOBER TERM, 1960

JOHN T. JARECKI, FORMER COLLECTOR OF INTERNAL REVENUE, ET AL., PETITIONERS

v.

G. D. SEARLE & CO.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

POLAROID CORPORATION, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

REPLY BRIEF FOR THE PETITIONER IN NO. 151 AND FOR THE RESPONDENT IN NO. 169

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The main question in these cases is whether the taxpayers' income from inventions can qualify as income from "discovery" within the meaning of § 456 (a)(2)(B), a question dealt with at length in our

opening brief in No. 151 and on which no further comment is necessary. Both taxpayers, however, make an alternative argument that, even if none of their income can qualify as "discovery" income within subparagraph (B), they are nevertheless entitled to relief under the last sentence of § 456(a)(2). Searle Br. 40–44; Polaroid Br. 27–33. The purpose of this brief is to answer that alternative argument in more detail than was done in our opening brief.

The question is what, if any, kinds of income other than the four enumerated classes can qualify as "abnormal income" as defined in § 456(a). The language of the section directly relevant to that question is:

> (a) *Definitions.*—For the purposes of this section—
>
> (1) *Abnormal income.*—The term "abnormal income" means income of any class described in paragraph (2) includible in the gross income of the taxpayer * * * if * * * the amount of such income of such class includible in the gross income of the taxable year is in excess of 115 per centum of the average amount of the gross income of the same class for the four previous taxable years * * *.
>
> (2) *Separate classes of income.*—Each of of the following subparagraphs shall be held to describe a separate class of income:
>
> (A) * * * [awards, judgments, or decrees]; or
>
> (B) * * * [exploration, discovery, or prospecting]; or

(C) * * * [sale of patents, formulae, or processes]; or

(D) * * * [change of accounting methods].

All the income which is classifiable in more than one of such subparagraphs shall be classified under the one which the taxpayer irrevocably elects. The classification of income of any class not described in subparagraphs (A) to (D), inclusive, shall be subject to regulations prescribed by the Secretary.

The basic contention of taxpayers is that, by virtue of the last sentence, the definition of "abnormal income" is not limited to the enumerated classes but potentially includes *all* items of income of whatever nature. The argument, in substance, is that every item of income necessarily belongs to some "class" and that the only discretion given the Secretary by the last sentence is over the grouping—*i.e.*, which items of income belong together in one class and which belong in another. Once the allocation of the items to their proper classes is accomplished, however, it follows, say the taxpayers, that any class, whatever its nature, can qualify as "abnormal income" provided only that it exceeds 115% of the prior four-year average of income of that class.

Reading the last sentence of paragraph (2) by itself, taxpayers' claim that it provides for the "classification" of all income is superficially plausible. The difficulty is that there is nothing in that sentence, or elsewhere in the section, to say that all income which is "classified" is eligible to qualify as "abnormal income". To the contrary, we will show (1) that, read-

ing the section literally, that sentence provides for a "classification" that has no operative effect and is mere surplusage and (2) that it was included in the statute only by inadvertence. Alternatively, we will show (3) that if the sentence is to be given any effect at all it must be given a much more limited effect than taxpayers claim in order to reconcile it with other action taken by Congress.

I

READ LITERALLY, THE LAST SENTENCE OF SECTION 456(a)(2) PROVIDES FOR A CLASSIFICATION THAT HAS NO OPERATIVE EFFECT

The first sentence of § 456(a)(1) limits the definition of abnormal income to "income of any class *described in paragraph (2)*." Paragraph (2) then provides that subparagraphs (A) to (D) "shall be held to *describe* a separate class of income." After the enumeration, there follows the provision that "The classification of income of any class *not described* in subparagraphs (A) to (D), inclusive, shall be subject to regulations prescribed by the Secretary."

Reading those several provisions literally, the last sentence has no operative effect. The definition of abnormal income in paragraph (1) applies only to the classes of income which are "described" in paragraph (2). The last sentence of paragraph (2) does not "describe" any class of income but rather permits the "classification" of classes "not described" in that paragraph. Hence, while the last sentence provides for the "classification" of undescribed income, there

is no operative provision to attach any consequences to that "classification." The last sentence, in short, provide for a classification which is of no consequence.

While ordinarily a statute should be read, if possible, so as to give effect to each provision, that rule of construction cannot resolve the dilemma posed by § 456(a). The reason is that the taxpayers' reading of the last sentence as meaning that *all* kinds of income are not only to be "classified" but are impliedly made eligible to qualify as "abnormal income" (subject only to the quantitative test) would equally deny any effect to a provision of paragraph (1)—namely, the phrase, "described in paragraph (2)." Under taxpayers' interpretation, paragraph (1) would mean exactly the same thing as it would if that phrase were deleted and it read:

> The term "abnormal income" means income of any class ~~described in paragraph (2)~~ includible in the gross income of the taxpayer * * * if * * * the amount of such income of such class [exceeds 115% of the four-year average] * * *.

That is, if paragraph (2) is interpreted as "describing", by virtue of the last sentence, *all* classes of income, the limitation of paragraph (1) to the classes "described in paragraph (2)" serves no function whatever.

II

THE LEGISLATIVE HISTORY SHOWS THAT THE LAST SENTENCE OF SECTION 456(a)(2) WAS INCLUDED BY INADVERTENCE

The origin of the last sentence of § 456(a)(2) can be best shown by tracing the development of that section from its counterpart, § 721, in the World War II law.

1. As originally enacted in 1940, § 721 was explicitly limited in application to six enumerated classes of income.[1] In the 1941 amendments (55 Stat. 17), which generally liberalized the relief provisions, § 721 was cast in a new form. It retained the six enumerated classes as "separate" classes of income to which the section applied, but also authorized relief for other classes. The form, it will be seen, was identical to that of § 456(a), except that paragraph (1) of § 721(a) did not include the phrase "described in paragraph (2)":

> (a) *Definitions.*—For the purposes of this section—
>
> (1) *Abnormal income.*—The term "abnormal income" means income of any class includible in the gross income of the taxpayer

---

[1] Section 721 of the original Act, 54 Stat. 974, provided:

> If there is includible in the gross income of the taxpayer for any taxable year an item of income of any one or more of the following classes:
>
> * * * [(a)-(f) omitted];
>
> and * * * the item includible in the gross income of the taxable year is grossly disproportionate to the gross income of the same class in the four previous taxable years, then [the amount attributable to other years may be reallocated to those years] * * *.

> * * * if * * * the amount of such income of such class [exceeds 125%] of the prior four-year average] * * *.
>
> (2) *Separate classes of income.*—Each of the following subparagraphs shall be held to describe a separate class of income:
>
> * * * [(A)–(F) omitted].
>
> * * * The classification of income of any class not described in subparagraphs (A) to (F), inclusive, shall be subject to regulations prescribed by the Commissioner with the approval of the Secretary.

In that statute, the last sentence of paragraph (2) performed an obvious and necessary function. Unlike § 456(a)(1), § 721(a)(1) did not limit the qualifying classes of income to those "described in paragraph (2)"; rather, it defined "abnormal income" as meaning "income of any class includible in the gross income of the taxpayer" which met the quantitative test—in short, any and all classes of income. That definition made it necessary to provide for the classification of *all* income into separate classes (the particular grouping of income into classes being of obvious importance in the application of the quantitative test separately to each class). That, in turn, was the function of pargaraph (2): it enumerated six "separate" classes of income and left to regulations the "classification" (*i.e.*, grouping) of all other items of income.

The breadth of § 721(a), it may be seen, did not derive (as Polaroid claims, Br. 28) from the last sentence of paragraph (2), but from the broad definition of "abnormal income" in paragraph (1). Paragraph (2), as its heading states, was but a defini-

tion of what constitutes "separate classes of income." It was solely and exclusively a "classification" provision, governing the accounting breakdown of a taxpayer's income into its constituent "classes." Once the income was grouped into its proper classes, the function of paragraph (2) was at an end, and which, if any, of those classes were eligible to qualify as "abnormal income" depended entirely upon the definition of *that term* in paragraph (1). The breadth of § 721(a) thus derived solely from the fact that *paragraph (1)* defined "abnormal income" as including "income of *any* class," without limitation, which met the quantitative test. The last sentence of paragraph (2) was merely an accounting provision made necessary by that definition.

We may note that the comprehensive definition of "abnormal income" in § 721(a) did not mean that any income which met the quantitative test was entitled to relief. The operative relief provision was § 721(b), which granted relief only to that part of any "abnormal income" which was "attributable" to other years. The effect of the definition of "abnormal income" was to impose solely a quantitative test in qualifying income as "abnormal", while leaving to the attribution requirements of subsection (b) the function of limiting relief to the appropriate *kinds* of income. The net result, which the committee reports show was precisely

what was intended,[2] was that any kind of income which was abnormal in amount and was in fact attributable to other years was eligible for relief under § 721 of the World War II law.

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[2] H. Rep. 146, 77th Cong., 1st Sess., pp. 3, 9–10; S. Rep. 75, 77th Cong., 1st Sess., pp. 3, 10:

> Existing law provides for adjustments with respect to six specific classes of abnormal income received during the taxable years subject to the excess-profits tax. These specific items were allowed to be spread over the years to which they are actually attributable. Your committee feel that the relief afforded by this provision should not be limited to these specific items but should be available also with respect to any item of abnormal income as such income is defined in the bill.
>
> * * * * *
>
> Section 721 of the present law provides relief with respect to certain abnormalities in income in the taxable period. These abnormalities, six in number, are specifically described. * * * It is believed advisable to extend the principle of this section to any abnormal item of income. As the types of abnormal income that may occur cannot be predicted in advance, adequate relief can only be granted by thus extending the scope of this section.
>
> The test of whether an item is abnormal is clarified to provide expressly that if the item includible in the gross income of the taxable year is in excess of 125 percent of the average amount of the gross income of the same class for the 4 previous years it shall be considered abnormal. * * * The mere fact that an item includible in the gross income of the taxpayer is * * * in excess of 125 percent of the average amount of the gross income of the same class for the test period, does not result in the exclusion of such item from excess-profits net income. It is necessary that the item be found attributable to other taxable years. Consequently, if an increase in business renders an item of income in excess of 125 percent of the income for the test period, the increase in business will not result in such increased income being excluded from excess-profits net income.

That is also, of course, the very effect that taxpayers would attribute to the successor provision in the Korean War law, § 456. We will show, however, that § 456 contained a very significant change from the terms of § 721.

2. As it was reported by the House committee and passed by the House, paragraph (1) of § 456(a) (there numbered § 454) of the Korean War bill (H.R. 9827, 81st Cong.) was identical to paragraph (1) of § 721 of the World War II law, except that the quantitative test was reduced from 125% of the four-year average to 115%. Thus "abnormal income" was still comprehensively defined as "income of any class includible in * * * gross income" which met the quantitative test. The opening and closing sentences of paragraph (2) were also the same, and the only change was in the enumerated classes, which were changed to read as they do in the law as finally passed. Most of the changes in the enumerated classes, moreover, simply reflected the addition of special provisions elsewhere in the act to deal with the specific items of income removed from those classes. The only substantive change was in the substitution of subparagraphs (B) and (C) of § 456(a)(2) for subparagraph (C) of § 721(a)(2). Old subparagraph (C) had defined as a separate class of income:

> (C) Income resulting from exploration, discovery, prospecting, research, or development of tangible property, patents, formulae, or processes * * *;

New subparagraphs (B) and (C) defined as separate classes of income:

> (B) Income resulting from exploration, discovery, or prospecting * * *;

(C) Income from the sale of patents, formulae or processes * * *;[3]

Thus, "Income resulting from exploration, discovery, or prospecting" was placed in a separate class by itself, and there was removed from the enumeration entirely all "Income resulting from * * * research, or development of tangible property, patents, formulae or processes" except that arising from the sale of the patent, formula, or process itself—*i.e.*, eliminating income from the taxpayer's use or licensing of the patent, etc., or from the sale of manufactured items (*i.e.*, "tangible property") developed by the taxpayer.

The elimination of those items of income from the enumerated classes in the House bill, without changing the definition of "abnormal income" in paragraph (1), literally had little effect. Paragraph (1) still defined "abnormal income" as including "income of *any* class includible in * * * gross income" which met the quantitative test, and the items of income removed from the specifically-described classes would still be a part of *some* class of income. Thus, under the literal wording of the bill as drafted by the House committee, the only effect of the change would seem to have been to require the items taken out of the enumerated classes to be placed in a different class under the last sentence of paragraph (2) providing for the classification of "any class" of income not included in the described classes.

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[3] The omission from each of the three quoted provisions is of the phrase: "or any combination of the foregoing, extending ["developed", in the last quoted provision] over a period of more than 12 months."

The House committee reporting the bill, however, obviously thought its changes had done more than that. The committee report, after explaining the nature of the relief under § 456, stated (H. Rep. 3142, 81st Cong., 1st Sess., p. 13):

> Adjustments of this type are limited to income arising out of—
>
> 1. A claim, award, adjustment, or decree;
>
> 2. Exploration, discovery, or prospecting which extended over a period of more than 12 months;
>
> 3. The sale of patents, formulas, or processes developed over a period of more than 12 months; or
>
> 4. Income which is includible in the taxable year rather than another year by reason of a change in the taxpayer's method of accounting.
>
> The equivalent provision in the World War II law (section 721) also permitted adjustments with reference to certain other types of income, particularly that resulting from the sale of tangible property arising out of research and development which extended over a period of more than 12 months. This provision in the old law was a potential loophole of major dimensions. Because there appeared to be no means of restricting such an adjustment to truly meritorious cases other than by the introduction of a large degree of administrative discretion of the type required by the general relief clause of the World War II law (sec. 722), and because the need for a reallocation of such income seemed to be materially less than in the other classes of income described above, this item has been omitted from the list of ab-

normal types of income for which a reallocation can be made under this bill.

The report thus speaks of the bill as though it limited relief to the specifically enumerated classes of income, so that the effect of the elimination of research and development income from the enumerated classes would be to make such income not eligible for relief at all. In fact, however, the bill reported by the committee and passed by the House simply did not conform to the report, for it retained both the all-inclusive definition of abnormal income (paragraph (1)) and the all-inclusive provision for the classification of income not within the enumerated classes (the last sentence of paragraph (2))—provisions identical to those adopted in the 1941 amendments to § 721 for the very purpose of expanding relief beyond the enumerated classes.

When the bill got to the Senate, the error of the House was recognized and sought to be corrected. The Senate committee adopted verbatim the House committee's *report* but amended the House *bill* so that it would have the effect attributed to it by the report. It accomplished that by two amendments, both passed by the Senate. By Amendment No. 200, it restricted the comprehensive definition of "abnormal income" in paragraph (1) by adding the phrase "described in paragraph (2)," so that it read:

> (1) *Abnormal income.*—The term "abnormal income" means income of any class *described in paragraph (2)* includible in the gross income of the taxpayer * * * if * * * the amount of such income of such class [exceeds 115% of the four-year average] * * *.

Having limited the definition of abnormal income to the described classes, there was no longer any need for the last sentence of paragraph (2) providing for the "classification" of income not included in the described classes, and that sentence was accordingly deleted by Amendment No. 201. With those corrections, the bill meant exactly what the House committee had intended it to mean—namely, that relief is available only for the four classes of income specifically described and that income from the sale of tangible property attributable to research and development activities in prior years is *not* eligible for relief.

Had the bill been adopted as amended by the Senate, there would of course be no issue in these cases. The difficulty arises from the inexplicable action taken by the conference committee, the report of which recommended to the respective Houses (H. Rep. 3231, 81st Cong., 2d Sess., p. 1):

> That the Senate recede from its amendments numbered * * * 201 * * *.
>
> That the House recede from its disagreement to the amendments of the Senate numbered * * * 200 * * *.

The conference, in short, accepted the Senate's limitation of the definition of abnormal income to the classes "described in paragraph (2)" but rejected the deletion of the last sentence of paragraph (2) providing for the "classification of income of any class *not described*" in paragraph (2). The action, it may be seen, was contradictory: the conference accepted the amendment to paragraph (1) that rendered the last sentence of paragraph (2) surplusage

but then rejected the deletion of that sentence.[4] In turn, of course, it was in the form recommended by the conference committee that the bill was finally adopted.

The only explanation that can be given for the retention of the last sentence of paragraph (2), notwithstanding the amendment of paragraph (1) in a way depriving that sentence of any operative effect, is, we believe, that it was the product of inadvertence resulting from the great speed with which the Act was drafted and passed by Congress. Under those circumstances, there is no occasion, we submit, to strain the other language of § 456(a) to give effect to that sentence. If, as we have shown above, that sentence is without operative effect upon a literal reading of the section, it can properly be treated as surplusage which found its way into the Act simply by oversight. Not only does that treatment not offend any rule of construction—since to give effect to that sentence would require denying effect to another provision (the limitation of abnormal income to the "described" classes)—but it is essential if effect is to be given to the Congressional intent as unequivocally stated in the committee reports and as manifested by

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[4] Nor is any explanation offered by the statement of the House managers, which merely includes Amendment No. 200 (to paragraph (1)) among a group described as "clerical amendments" to which the House agrees and then describes Amendment No. 201 (to paragraph (2)) as one which "relates to classes of abnormal income attributable to other taxable years" and from which the Senate recedes. H. Rep. 3231, *supra*, pp. 23, 24.

the amendment made to paragraph (1) to limit the definition of "abnormal income."[8]

In summary, we submit that the inconsistency between paragraph (1) (limiting eligibility for relief to the classes of income "described in paragraph (2)") and the last sentence of paragraph (2) (providing for the classification of *any* class of income not expressly described) should be resolved as follows: the committee reports show that both Houses of Congress intended to limit relief to the four classes of income specifically enumerated and to deny relief to income from research and development. The Senate amendment to paragraph (1) limiting its scope to the classes of income "described in paragraph (2)" would, given its literal meaning, fully accomplish that purpose, for that restriction of paragraph (1) leaves the last sentence of paragraph (2) without operative effect—while it provides for the classification of other income, the resulting "classes," not being "described in paragraph (2)", simply fail to come within the operative definition of "abnormal income" in paragraph (1). On the other hand, if effect is sought to be given to the last sentence of paragraph (2) by reading paragraph (1) as impliedly including within the definition of abnormal income not only the classes specifically

[8] We may note that Polaroid's recitation of the history of the last sentence of paragraph (2)—noting that it was stricken by the Senate and restored by the conference—simply ignores the related amendment made to paragraph (1). See Polaroid Br. 28–29. How that amendment, restricting "abnormal income" to the classes "described in paragraph (2)", can be reconciled with the all-inclusive effect it would give to the last sentence of paragraph (2), Polaroid does not undertake to explain.

"described in paragraph (2)" but also "income of any class not described" in paragraph (2) but subject to "classification" under the last sentence—in short, *all* income—the result would be to deny any effect to the addition to paragraph (1) of the phrase "described in paragraph (2)" and frustrate the purpose of Congress to restrict relief to the enumerated classes. Since either interpretation renders some part of the statute superfluous and the more literal interpretation is the one conforming to the disclosed intention of Congress, that interpretation (with abnormal income being limited to the classes "described in paragraph (2)") should be accepted. It should be recognized that the last sentence of paragraph (2) was deprived of any operative effect by the adopted amendment to paragraph (1) and was left in the statute only by oversight.

III

IF ANY EFFECT IS TO BE GIVEN TO THE LAST SENTENCE IT MUST BE NARROWLY CIRCUMSCRIBED TO AVOID FRUSTRATING THE CONGRESSIONAL PURPOSE

The purpose of this Point is to examine how, if it is thought to be inappropriate to give no effect to the last sentence of § 456(a)(2), some effect might be given to it while at the same time also giving some effect to the limitation of the definition of "abnormal income" in paragraph (1) to the "described" classes of income.

1. There are, as we have seen, two steps in defining "abnormal income": first, the "classification" of income into separate classes; and, second, the specification of which of those classes are "eligible" to qualify as abnormal income if they meet the quantitative test. The

last sentence of (a)(2) deals in terms only with "classification" and not with "eligibility", and, read as a "classification" provision, it seems to contemplate that all income is classifiable into some class or another. That was clearly the meaning of the same language in the World War II law, for § 721(a)(1) defined "abnormal income" as meaning "income of *any* class includible in * * * gross income" which met the quantitative test, thus making it necessary to provide in (a)(2) for the "classification" of *all* income.

In § 456(a), however, the last sentence of (a)(2) would have no effect if read as purely a "classification" provision, for there is nothing to make the income so classified *eligible* to qualify as abnormal income (*i.e.*, with the definition of abnormal income having been limited to the "described" classes of income). Hence, to give any effect to the last sentence, it must be read as an "eligibility", as well as a "classification", provision—that is, it must be read as meaning that the regulations are to govern not only the classification of the unenumerated kinds of income but also the eligibility of the additional "classes" to qualify as abnormal income.

If the last sentence of (a)(2) is to be read as an eligibility provision, however, it must necessarily be given something less than the all-inclusive scope it seems to have as a classification provision. For if it were interpreted to mean not only that all income is to be classified but that *all* of the resulting classes are eligible to qualify as abnormal income, it would deny any effect to the limitation of (a)(1) to "described" classes and frustrate the expressed purpose of Congress to restrict the scope of § 456(a). And the only way that the last

sentence can be given less than an all-inclusive scope is to read it as delegating to the Secretary the power, by regulations, to specify what additional classes of income, less than all, are eligible for relief. In short, any reconciliation of the last sentence of (a)(2) with the limitation added to (a)(1) and the legislative history requires that the Secretary be given the function, not only of "classifying" income but of determining its "eligibility" for relief.

That interpretation of the last sentence of (a)(2) appears to have been adopted by the Staff of the Joint Committee on Internal Revenue Taxation in its "Summary of * * * 'The Excess Profits Tax Act of 1950' as Agreed to by the Conferees." The staff summary, in describing the relief provided for abnormal income, states (p. 9):

> Adjustments of this type are limited to income arising out of—
>
> (1) * * * [(1) to (4), reciting the four enumerated classes, omitted]; or
>
> (5) income of other classes permitted under regulations prescribed by the Secretary.

It may be seen that the summary, although otherwise taken verbatim from the House and Senate committee reports (see pp. 12-13, *supra*), differs from them in recognizing for the first time (by the addition of paragraph (5)) the existence of the last sentence of § 456(a)(2) of the bill. It reads that sentence, however, not as meaning that *all* classes of income are eligible for relief, but as meaning only that the Secretary may "permit" certain additional classes to be added to the kinds of income to which the relief is

"limited." That is, relief is still "limited" to less than all classes of income, but the Secretary has power to add one or more classes to those described in the statute.[6]

If, however, the statute is read as delegating a power to determine the eligibility of additional classes, it is necessary to find in it some standards by which the Secretary is to exercise that power. Since none are stated, they can be found only by inference from the enumerated classes, their history, and the purpose of the relief provision as a whole. It can be inferred, first, that relief should be limited to classes of income essentially similar in nature, and in the need for allowing such an adjustment, to the four classes specifically enumerated. By that standard, for example, income from the sale of copyrights, being essentially similar—both in nature and in the policy justifications for granting relief—to that from the sale of patents, might be allowed as an additional class. Of particular importance here, however, is the clear indication found in the legislative history that income from the sale of tangible property (*i.e.*, manufactured articles) ought not be reallocated to prior years simply because research and development expenses were incurred in prior years in developing the article. That that is one kind of income that Con-

[6] That interpretation is also consistent with the statement of Senator George on the floor of the Senate that the bill, as agreed to by the conference committee, "would give the Secretary of the Treasury the *authority* to prescribe classifications in addition to those specified in the bill." 96 Cong. Rec. 16,978 (emphasis added).

gress did *not* want to be made eligible is established not only by the committee reports but by the deliberate omission of that particular kind of income from the enumerated classes otherwise taken from § 721(a) of the World War II law. That is to say, even without reliance on the committee reports, it can be inferred from a comparison of § 456 with its predecessor that Congress, in eliminating that kind of income from the enumerated classes, did not want it brought back into the statute under the power delegated to the Secretary by the last sentence.

In summary, if any effect is to be given to the last sentence of paragraph (2) it should be interpreted as at most delegating to the Secretary a discretionary power to extend relief to additional kinds of income essentially "similar" to the enumerated classes, specifically excepting, however, income from the sale of tangible property attributable to prior years solely on the basis of research and development expenditures made in the prior years.

2. To the extent that they give any effect to the last sentence of (a)(2), the regulations under § 456 give to it only the limited effect suggested above. Their significance can best be seen from their development from the corresponding regulations under § 721 of the World War II law.

Under § 721, as we have pointed out, the last sentence of (a)(2) meant what it literally said, simply providing for the classification of *all* income not within the described classes, such classification being necessary because of the definition of abnormal income in (a)(1) as including "income of any class

includible in * * * gross income." The regulations, in turn, followed that evident meaning and provided simply that (Regs. 112, § 35.721–2):

> * * * Income which does not fall within those provisions [*i.e.*, the enumerated classes] may be grouped by the taxpayer, subject to approval by the Commissioner on the examination of the taxpayer's return, in such other classes as are reasonable in a business of the type which the taxpayer conducts, and as are appropriate in the light of the taxpayer's business experience and accounting practice.

That provision seems clearly to have contemplated that all income could be grouped in one class or another and that the Commissioner's review would go only to the breakdown as between classes—*i.e.*, he could disapprove the inclusion of a particular item in one class rather than in another. The regulations in no way dealt with the *eligibility* of the classes to qualify as "abnormal income," for under § 721(a)(1) "any class" was expressly made eligible.

With the change in the definition of abnormal income in § 456(a)(1) of the Korean War law, the draftsmen of the regulations were faced with a difficult problem in giving effect to the last sentence of (a)(2). Although the language of the sentence was the same as that of § 721(a)(2), it was evident that it could not be given the same effect without destroying the limitation added to § 456(a)(1), and what other effect might be given to it was, as we have shown, a question of considerable difficulty. The solution adopted seems to have been, in substance, to preserve the ambiguity of the statute as to whether any

classes other than those enumerated could qualify and to limit the additional classes, if any, to those "similar" to the enumerated classes. As first issued, the relevant provision of the regulations consisted of one sentence reading as follows (Regs. 130, § 40.456–2(b); emphasis added):

> (b) Other income, not within a class described in subparagraphs (A)–(D) of section 456(a)(2), *to which section 456 is applicable* may be grouped by the taxpayer, subject to approval by the Commissioner on the examination of the taxpayer's return, in such classes *similar to those specified* in subparagraphs (A)–(D) of section 456(a)(2) as are reasonable in a business of the type which the taxpayer conducts, and as are appropriate in the light of the taxpayer's business experience and accounting practice.

The form of the regulations, it may be seen, was borrowed from the regulations under § 721(a)(2), but with two significant additions (italicized above) the effect of which was to leave open the question whether § 456 was in fact "applicable" to any classes of income other than those enumerated and, assuming that it was "applicable" to some other income, to limit eligibility to kinds of income which were "similar" to the enumerated kinds.

On December 4, 1952, a proposed amendment to the regulations was published (17 F.R. 10973) which would have added to the original sentence the following two sentences:

> Income from the sale of tangible property, however, even though such income may arise out of research and development which has ex-

> tended over a period of more than 12 months is not income to which section 456 is applicable. Such income from the sale of tangible property accordingly may not constitute or be included in any class of income for purposes of section 456(b).

Upon protests to the proposed amendment being received and considered, the two sentences were revised and adopted (T.D. 6026, 1953–2 Cum. Bull. 235) in the following form:

> Income from the sale of tangible property arising out of research and development which extended over a period of more than 12 months is not included in the list of abnormal types of income to which section 456 is applicable, and such income may not constitute a class of income for purposes of that section. However, section 456 is applicable to such income if the income is otherwise properly includible within a class of income to which such section is applicable, for example, the class described in section 456(a)(2)(D).

The reasons for the change in the form of those two sentences seems apparent. As originally proposed, the amendment, by excluding income "from the sale of tangible property" from any class of income eligible under § 456, had the obviously unintended implication that income from the sale of mineral products would be excluded even though arising in part from "discovery" and thus specifically included in § 456(a)(2)(B). Additionally, of course, it would have excluded income from research and development even if it otherwise fell within one of the enumerated

classes (*e.g.*, judgment income or income includible in the taxable year because of a change in accounting methods). The revised amendment overcame those objections by making clear that such income was eligible if a part of some other class "to which [§ 456] is applicable"—*i.e.*, if it fell within one of the enumerated classes or such other additional classes, if any, brought into the section by the last sentence of (a)(2).

The important thing is that the regulations reject any implication that the last sentence of (a)(2) means that *all* classes of income are eligible. At most, the regulations extend relief only to classes of income "similar" to the enumerated classes, and even that is limited by the next sentence expressly denying relief to income from the sale of tangible property arising out of research and development. In short, the regulations, to the extent that they give effect to the last sentence of (a)(2),[7] adopt the interpretation of that sentence we have suggested above—namely, as delegating to the Secretary the power to make additional classes of income eligible for relief, the additional classes to be determined by the degree of their "similarity" to the enumerated classes, subject, however, to the specific exclusion of research and development income as an eligible class.

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[7] We may note, however, that the regulations, by carefully referring only to "Other income * * * to which section 456 is applicable," leave open the question whether § 456 is in fact "applicable" to any other income besides the enumerated classes. Hence, it would not be inconsistent with the regulations for the Court to hold, as we have previously suggested, that the last sentence of (a)(2) is surplusage and has *no* operative effect.

3. Under the foregoing interpretation of the last sentence of § 456(a)(2) and of the regulations thereunder, it is plain that neither taxpayer here is entitled to relief. Taxpayers argue that part of their income from sales of Dramamine and Banthine (Searle) or from sales of Polaroid cameras or 3-D glasses (Polaroid) is income arising from their "discovery" of those products and is thus of a nature "similar" to one of the enumerated classes (income from "discovery" of minerals), thereby qualifying it as an additional class eligible for relief under the first sentence of the regulations (§ 40.456–2(b)). We need not debate the degree of "similarity" between those classes of income, for the general standard of the first sentence of the regulations is in any event qualified by the specific provision of the second sentence expressly denying eligibility to research and development income as an additional class (*i.e.*, unless such income is a part of another class of income otherwise eligible for relief).

Plainly, the basis for taxpayers' claim for relief is that a part of their income from the sale of their patented products is "Income from the sale of tangible property arising out of research and development * * *." While the income might also be described by various other of its numerous characteristics (*e.g.*, camera income, sales income, manufacturing income), the only characteristic relevant to the claim that allowance of relief under § 456 is appropriate is that the income is attributable in part to research and

development activities occurring in prior years. The very purpose of the second sentence of the regulations is, in turn, to make clear that that characteristic of an item of income is not sufficient to qualify it for relief.

In the end, taxpayers are seeking to obtain relief under the last sentence of § 456(a)(2) for precisely the kind of income that was specifically enumerated in the World War II law (§ 721(a)(2)(C)) and specifically deleted from the enumeration in the Korean War law. Even if the last sentence of § 456(a)(2) is read as authorizing the Secretary to extend relief to some kinds of income not included in the enumerated classes, it was certainly not intended, by that means, to bring back within the statute the very kind of income which Congress deleted because of the experienced difficulties in applying the relief provisions to it. The expressed determination of the Secretary, by the regulations, that income is not eligible for relief simply because it is attributable in part to research activities in prior years is, therefore, fully consistent with the revealed Congressional purpose and hence a valid exercise of the power delegated to the Secretary to determine the eligibility of unenumerated kinds of income.

The taxpayers in these cases can ultimately prevail, therefore, only on their argument that the last sentence of § 456(a)(2) means that *all* classes of income, of whatever nature, are eligible to qualify as "abnormal income" so long as they meet the quantitative

test.[8] As we have pointed out, however, giving that effect to that sentence would deny any effect to the "described in paragraph (2)" limitation added to §456(a)(1). That would frustrate completely the purpose of Congress, unequivocally shown in the legislative history, to restrict the scope of the "abnormal income" definition and, in particular, to remove research and development income from its reach. There is no warrant for such a reading, we believe, either in the literal wording of that sentence (which provides only for the "classification" of income without prescribing the consequences of the classification) or in the history of the section. In our view, the sentence should either be recognized as surplusage and be given no effect at all, or at most be given the limited effect

[8] Even that interpretation, while it might entitle Polaroid to some relief, would probably be of no avail to Searle. Even if "abnormal income" includes any "class" of income, there still remains the question of "classification" as such—*i.e.*, the scope of the "class" to which the quantitative test is to be applied. In the case of Polaroid, it appears that it might meet the quantitative test however its total income is classified, for it might perhaps meet the test even if all of its income were grouped into a single class (*i.e.*, the broadest possible "class"). In the case of Searle, however, it appears (though the record is incomplete) that it can meet the quantitative test only if it is able to segregate its income from Dramamine and Banthine into a class separate from its income from the sale of its other ethical drugs. The only basis it suggests for segregating those items from its other drugs is that they were major "discoveries", while its development or improvement of its other products by research and development involved only, to use Searle's language, little "discoveries." That is plainly not an adequate basis for separate classification, and the Commissioner's rejection of that classification was fully within the discretion given him by the statute and regulations.

suggested in this Point, in either of which events taxpayers here cannot qualify for relief under that sentence.

Respectfully submitted.

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MARCH 1961.

U.S. GOVERNMENT PRINTING OFFICE: 1961